RECEIVED

MAY - 9 1994

FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF SECRETARY

Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

In the Matter of	)	
Price Cap Performance Review	)	CC Docket No. 94-1
for Local Exchange Carriers	)	

COMMENTS OF AMERITECH

MICHAEL S. PABIAN

2000 West Ameritech Center Drive
Room 4H76
Hoffman Estates, Illinois 60196-1025
(708)248-6044

Attorney for Ameritech

Dated: May 9, 1994

TABLE OF CONTENTS

RECEIVED

MAY - 9 1994

FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF SECRETARY

Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

In the Matter of	)	
Price Cap Performance Review	)	CC Docket No. 94-1
for Local Exchange Carriers	)	

COMMENTS OF AMERITECH

Ameritech[1] submits these comments in response to the Commission's Notice of Proposed Rulemaking in this proceeding.[2]

I. INTRODUCTION AND SUMMARY

This proceeding marks the scheduled fourth year review of price cap regulation for local exchange carriers ("LECs"). The evidence will demonstrate that the Commission's price cap plan has, for the most part, been successful. As the Commission itself noted, the price cap LECs' interstate access rates are currently $1.5 billion lower than they were at the start of price caps in the face of an overall price inflation of 11.6 percent.[3] In fact, Ameritech's current rates are almost $92 million below cap, spread across all baskets.[4] Infrastructure development has been proceeding apace, and telephone subscribership is at an all time high.[5] Moreover, LEC service performance has been reasonably maintained.[6] Thus, customers have fared well under price caps.

---

[1] Ameritech means Illinois Bell Telephone Company; Indiana Bell Telephone Company, Incorporated; Michigan Bell Telephone Company; The Ohio Bell Telephone Company; and Wisconsin Bell, Inc.

[2] In the Matter of Price Cap Performance Review for Local Exchange Carriers, CC Docket. No. 94-1, Notice of Proposed Rulemaking, FCC 94-10 (released February 16, 1994) ("NPRM").

[3] Id. at ¶ 25.

[4] This, however, is more an indication of the competitive pressure faced by Ameritech than it is the result of the price cap plan itself.

[5] NPRM at ¶ 29.

The discussion in this proceeding, however, will also show that the plan must be improved to align it more closely with its original goals of providing for reasonable rates while at the same time offering incentives for LECs to become more efficient and to introduce new technologies and new services.

Specifically, in light of the increased competitive pressures to which price cap LECs are now subject, the baseline price cap structure and the underlying interstate rate elements should be modified in a manner generally consistent with USTA's access reform model, with certain enhancements. The price cap plan, as originally enacted, assumed a "bottleneck" status for LEC services. In order not to skew the competitive process, however, the degree of price regulation should abate as competitive pressures limit LECs' ability to raise rates to unreasonably high levels.

In addition, the Commission should eliminate sharing. Requiring carriers to "share" the benefits of their productivity efforts dilutes the incentive to engage in those efforts in the first instance. To the extent that sharing was designed as a "backstop" against a potentially erroneous initial industry-wide productivity offset figure, that uncertainty can be remedied by simply embedding price cap LECs' current sharing amounts into their baseline PCIs on a going-forward basis. By the third year into price caps, these sharing levels will provide a reasonable to high-side estimate of individual LECs' productivity going into price caps. Retaining sharing any further in the price cap plan poses a significant likelihood that the majority of additional productivity that would be shared would be the result of efficiency enhancing efforts that result from incentive regulation itself. That being the case, sharing can only dampen those efforts.

---

[6] Id. at ¶ 27-28.

Moreover, the price cap plan's treatment of optional new services should be completely revised to permit the market pricing of those services. Current regulatory treatment constitutes a significant impediment to the development of new service offerings. Instead, streamlined regulation is justified. Since the services are optional and new, their provision, at whatever price, can only increase customer options. If LECs wish to sell those services, they cannot charge more than customers are willing to pay. The fact that customers are currently "doing without" makes the market itself a reasonable check on the LECs' ability to charge.

Also, the plan's productivity factor should not be raised. The Commission intended for the price cap plan to encourage LECs to be more productive. If any increased productivity is wrested from subject carriers, the "incentive" portion of the plan will be seriously compromised.

Finally, the Commission's reporting requirements should not be increased and, as competition develops, regulation should apply on the same terms to all carriers. The regulatory burdens that remain in a competitive environment should fall equally on all participants.

II. GENERAL ISSUES

General Issue 1: Should the goals of the LEC price cap plan be revised?

The goals of price caps are valid. The original goals -- to ensure that rates are just, reasonable and nondiscriminatory and to promote a communications system that offers innovative, high quality services[7] -- are completely consistent

---

[7] Id. at ¶ 31.

with the Communications Act and public policy. These goals are laudable and serve the interests of both the customer of regulated services and the carriers themselves.

What should be changed however is the price cap system itself -- to better achieve the purposes for which it was originally created. These changes will be discussed more fully below.

General Issue 2: The effect of price caps on consumer welfare and the economy.

Studies and reports filed by USTA in connection with its comments in this proceeding demonstrate that further modification of the Commission's price cap regime to more closely align it with its original goals will produce tangible public benefits. The report of Professor Robert Harris and the study of Dr. Larry Darby demonstrate that price cap regulation should be modified to end residual earnings regulation, to streamline regulation for new services, and to equalize the regulation of all competitive service providers, including revisions to the plan to accommodate significant LEC pricing flexibility. These changes will result in greater LEC investment in new technologies and services and in an improvement in the competitive process which will give customers the benefits of true price competition. Such changes are necessary to accommodate price cap regulation to the real world in which LECs compete in capital markets for investor funds and where the LECs' customers for interstate services are mostly large and all relatively sophisticated and have options for the services those LECs currently provide. The changes to the price cap plan to permit more economically rational behavior can only serve to benefit the economy as a whole with a more economically rational allocation of resources.

III. BASELINE ISSUES

A. Infrastructure Development

Baseline Issue 1a: Should the Commission revise the LEC price cap plan to support the development of a ubiquitous national information infrastructure?

Baseline Issue 1b: Whether universal service goals are currently being met or whether the LEC price cap plan should be revised to ensure the provision of universal service.

There is no evidence that universal service needs are not being met generally by price cap LECs. However, the Commission's own figures indicating that telephone penetration is somewhat sensitive to household income levels below a certain threshold figure -- e.g., especially below $20,000 -- show the extreme inefficiency of attempting to achieve universal service by artificially suppressing rates that are available to the entire population.[8] With figures as dramatic as those cited by the Commission in the NPRM -- e.g., subscribership being 73.2% for households with incomes below $5,000 but 96.5% for households with incomes between $20,000 and $24,999 -- it is apparent that a narrower targeting of the benefits of any universal service subsidy program would be more economically efficient. While the federal lifeline assistance program is narrowly focused, the current carrier common line charge subsidy to end user-generated non-traffic sensitive costs is not.

As Ameritech has pointed out in its Customers First Plan filings,[9] as LEC services come under increasing pressure from competitive providers, it is

---

[8]Between 1985 and 1989, the state carrier common line charge was phased out in Illinois. In addition, Illinois Bell restructured local rates on a more economically rational basis. Neither of these changes had adverse effects on telephone subscribership levels.

[9]See, Petition for Declaratory Ruling and Related Waivers to Establish a New Regulatory Model for the Ameritech Region, filed by Ameritech on March 1, 1993, and supporting material filed April 16 and April 30, 1993, and Ameritech's Reply filed July 12, 1993.

necessary to remove the subsidy burden from competitive rates and, to the extent regulatory authorities wish to continue that subsidy, recover those costs in a competitively neutral manner. These changes are necessary not only to avoid distorting the competitive process, but also to ensure the long-term sustainability of the subsidy mechanism itself. USTA's access reform proposal makes a similar point that support mechanisms should be identified and located in a special public policy basket and charged to all industry providers.

The issues of the deployment of the national information infrastructure ("NII") and what universal service should look like in the future, however, are much broader than price caps and should be dealt with in a separate docket. Any regulatory changes that come out of that docket could be incorporated into a revised price cap structure at that later time. Ameritech would only note generally that the most economically efficient way to deploy the most advanced services to the most customers is to let the competitive process do the job. The regulatory process is particularly ill-suited to identifying future marketplace needs. Therefore, regulators should refrain from directing the deployment of specific types of advanced technologies or services.

Rather, regulators, including the Commission, should focus on removing regulatory impediments to the competitive process and disincentives to advances in technology and new service offerings. Ameritech's Customers First Plan describes one way in which this can be done most globally -- by unbundling the loop from the switch and integrating the end offices of competitive exchange providers while at the same time removing the MFJ restriction on the provision of interLATA services, and by adopting rule changes to permit pricing flexibility for services subject to competitive pressures. The USTA access proposal also offers a mechanism for the provision of increased pricing flexibility as competitive pressures increase within LEC servicing areas. Generally speaking, competitive regulatory parity is essential to ensuring that investment decisions aren't uneconomically skewed by regulatory advantage or disadvantage. Moreover, revision of the rules dealing with new services as discussed below will also remove another significant disincentive to the introduction and deployment of new services by price cap LECs. Further, the elimination of residual rate of return regulation -- in the form of sharing -- will remove a current disincentive to LEC investment in new technology to support existing and new service offerings. Thus, increasing pricing flexibility, reforming the rules governing the introduction of new services, and eliminating sharing are perhaps the most significant things the Commission can do in the context of this price cap proceeding to further the introduction and deployment of new services and technologies to the greatest number of customers.[10]

Baseline Issue 1c: Data on the replacement of copper technology with fiber.

Attachment A demonstrates that Ameritech has invested substantially in new technologies under price caps. Total fiber miles have more than tripled since 1989. The percent of customers served by digital lines has doubled, and there has been an eight-fold increase both in the percent of customer lines served by SS7 and the percent of customer lines with access to ISDN. Moreover, in connection with its proposed video dialtone offering, Ameritech is currently planning to construct a broadband distribution system that will pass a total of 6 million homes and businesses by the year 2000. However, Ameritech's future investment decisions will necessarily have to consider whether the rewards and benefits of introducing new technologies and services are significantly mitigated

[10]See generally the report of Professor Robert Harris and the study of Dr. Larry Darby submitted USTA's comments.

by residual earnings regulation devices such as the price cap plan's sharing provisions or by a regulatory gauntlet that must be run with the introduction of new services.

B. Composition Of Bands And Baskets

Baseline Issue 2: Whether the price cap baskets and bands should be revised?

For the purposes of conciseness and clarity, Ameritech plans to discuss in this section not only baseline changes to the price cap plan that should take place today, but also those changes that should occur as competition or competitive pressures increase. Since competition is here and is increasing, baseline and transitional changes can logically be considered as a whole. Ameritech's Customers First Plan and USTA's access reform proposal provide models for those changes to price cap regulation that are necessary to permit price cap LECs to effectively participate in today's increasingly competitive telecommunications marketplace.

The first change that should be made to the baseline plan is the treatment of new services under price caps. As described below in subsection H, those truly new services not mandated by the Commission should be subject to streamlined regulation. The current treatment of new services actually discourages investment and innovation.

A second change that should be made to the baseline plan is that interexchange services should also be subject only to streamlined regulation. Currently, interstate intraLATA and corridor services are offered by certain BOCs in very restricted geographic areas. It cannot be denied that these services are competitive. All major interexchange carriers provide competing services.

Price cap regulation makes no sense given the existence of substantial alternative sources of supply of these services.

Third, baseline price caps should be reconfigured along the lines proposed by USTA in its access reform petition[11] with some special important modifications. Under USTA's access reform proposal, market areas based on the LEC's wire center boundaries are classified as either Initial Market Areas ("IMAs"), Transitional Market Areas ("TMAs"), or Competitive Market Areas ("CMAs") depending on the degree of available alternative supply found in each area. IMAs are the baseline category. In IMA's the price cap rules would operate similar to the way they do today. Services would be separated into four baskets: public policy (covering interconnection and subsidy elements, including long term support, and the current carrier common line charge -- these subsidy elements to be recovered in a neutral manner), switching, trunking (transport), and other (covering rate elements that do not fit into the other baskets). Separate service bands would be established for the carriers' currently-approved "deaveraged" zones for switching, digital trunking and non-digital trunking. Band limits would be +5%/-10%.

Also, under USTA's plan, as competition appeared in a given wire center, it would become a TMA. The ordering of interconnection in the wire center would be sufficient to trigger the transformation but would not be necessary. The presence of a substitutable service from another source (including self-provisioning by a customer) would constitute evidence of competition. TMA's would be grouped into the same zones that were applicable to the wire centers as IMA's. Services would be in the same price cap baskets as IMA services but

---

[11]In the Matter of Reform of the Interstate Access Charge Rules, Petition for Rulemaking, RM-8356, filed September 17, 1993.

there would be separate service bands for TMA switching, digital trunking and non-digital trunking. Band limits would be +5%/-15%. Customer-specific competitive response pricing would be permitted.

Additional competitive pressure would justify more relaxed regulatory treatment under USTA's plan. Wire centers would be classified as CMAs when an alternative source of supply is available to customers representing at least 25% of the LEC's demand for interstate access services or 20% of the total market demand for interstate access services and when bids, private networks or self-provision are utilized by customers within the wire center representing at least 25% of the LEC's demand for interstate access services or by a single customer whose demand represents at least 15% of the LEC's demand for interstate access services. Services within CMAs would be outside the access rules. General tariff rates would be available in zones corresponding to IMA/TMA geographic areas; however, contract carriage would be permitted.

Ameritech, however, suggests the following enhancements to the USTA plan to better adapt it to the changing competitive environment. First, issuance of a bid request or RFP by a customer should be sufficient to establish a TMA -- to clarify that the LEC may in fact engage in competitive response pricing.

Second, USTA's CMA trigger criteria should be alternative rather than joint. The verifiable presence of alternative supply to a substantial number of customers and the solicitation for use of alternative sources by customers with substantial demand individually constitute substantial competitive pressure.

Third, additional individual alternative CMA triggers should be recognized -- specifically: the presence of substitutable service from two or more sources, the offering of unbundled loops by the LEC, and the offering of end-office integration to alternative exchange carriers ("AECs"). The latter two triggers would require special offerings by the LEC specifically to facilitate competition, like those contemplated by Ameritech's Customers First Plan. Offerings of this type have the real potential to unleash rapid growth in competition. Therefore, it makes sense to permit the LEC to respond to the resulting competitive potential in an economically rational way. Precluding this pricing flexibility until competition is present and entrenched could encourage inefficient investment in response to uneconomic signals conveyed by artificially controlled LEC prices.

Fourth, notice periods for in-band tariff filings would be shortened to 14 days for IMAs and one day for TMAs. Restructuring filings could be made on 21 days notice for IMAs and one days notice for TMAs.

Fifth, services in CMAs should be given full streamlined treatment as that term is applied to non-dominant carriers.[12] Tariffs would be effective on one days notice and no cost support would be required.

In general, this additional pricing flexibility will permit LECs to be more responsive to their customers' needs. In an increasingly competitive environment, that is essential. Moreover, consumer welfare is enhanced as LECs are permitted to price their services more in line with economic reality.

C. Changes In Productivity Factors Or Rate Levels

Baseline Issue 3a: Whether the productivity factor of the LEC price cap indices should be changed or whether a one-time change in the index should be required.

Baseline Issue 3b: If the factor should be changed, what method should be used?

---

[12]As noted above, however, interexchange and optional new services should be given streamlined treatment in all cases.

Assuming that the productivity offset factor was set correctly in the first instance -- i.e., that it was a reasonable estimate of what, in a cost-of-service regulation environment, would have been the LECs' productivity performance differential versus the economy as a whole -- then there is no reason for the productivity factor to be adjusted. Rates under price cap regulation are reasonable because the price cap formula precludes them from being higher in the aggregate than they would have been under the prior regulatory scheme. Moreover, the formula guarantees customers rate decreases in real terms. Every year, prices are capped at a level that declines relative to inflation. In return, carriers are given the incentive to become more efficient than they would have under cost of service regulation.

Certainly, it would be totally inappropriate and inconsistent for the Commission to seek to increase the price cap plan's productivity offset or to require a one-time adjustment to the LECs' price cap index in light of perceived LEC productivity increases. The Commission set the price cap plan's 2.8% base productivity offset figure as a reasonable estimate of what price cap LECs' productivity performance would have been under rate of return regulation. Assuming, for argument sake, that LEC productivity performance has increased under price caps, it is more likely than not to have been the result of the incentive aspects of price cap regulation itself. To require a give-back of those productivity gains either via a one-time (permanent) reduction to the LECs' price caps or by an increased productivity offset (whose effect is compounded) would impose retroactively the very disincentives to efficiency associated with cost of service regulation that price caps was supposed to correct. Certainly, if a LEC believes that any efficiency improvements will ultimately have to be given back, its inclination to engage significant resources in improvement efforts will be correspondingly reduced. The result would be a significant dilution, if not an out-right eradication, of the efficiency incentives of price cap regulation.

Further, the Commission has asked whether it should adopt a mechanism to adjust the plan to reflect changes in interest rates. The answer is that the Commission already has a mechanism that adjusts the plan to reflect those changes -- it is called the GNPPI. Interest is a cost of doing business for all firms in the economy. As costs change, firms adjust their prices. Those price changes are reflected in the GNPPI. Interest rate changes are similar to corporate tax rate changes. Even though the LECs cannot control interest rates or tax rates, interest and corporate taxes are a normal risk of doing business facing all firms in the economy. Since the Commission considers corporate tax rate changes as endogenous, interest rate changes should also be considered endogenous. An automatic adjustment to the price cap index is not needed for future changes in interest rates since those interest rate changes will be reflected in the GNPPI. Also, a one-time reduction due to the past interest rate changes is not appropriate since those interest rate changes have already been reflected in the GNPPI. Thus, no additional modifications of the price cap formula need be made for changes in interest rates.

Baseline Issue 3c: The reasonableness of price cap LECs' profit levels.

Yes, price caps LECs' profit levels are reasonable. Moreover, in comparison to the rest of the market, LEC regulated earnings are artificially inflated by arbitrarily low depreciation rates. By way of example, if Ameritech's interstate earnings were restated using the composite depreciation rate of 10.3% used by AT&T in 1992, Ameritech's rate of return would be about <u>400 basis points lower</u> than the return that was based on its mandated lower depreciation rates and reported on Form 492A. And, in any event, higher profit levels are exactly what the price cap plan anticipated. On the other side of the coin, customers have benefited from the rate reductions effected by the plan; and it is the rates customers ultimately care about -- not LEC profit levels. Thus, there should be no modifications of the plan to adjust for any variations in LEC profit levels from those prevailing at the plan's inception.

D. Sharing And Low-End Adjustment Mechanisms

Baseline Issue 4a: Whether the sharing and low-end adjustment mechanisms should be realigned with capital costs.

Baseline Issue 4b: Whether the sharing and low-end adjustment mechanisms should be revised or eliminated.

Clearly, the sharing mechanism should be eliminated as being inconsistent with the incentive intent of the price cap plan. Its residual earnings regulation character is a throw back to the prior regulatory regime and constitutes a significant mitigation of the efficiency incentive aspects of the Commission's price cap plan. Any price cap carrier's enthusiasm for a significant efficiency enhancing undertaking will be cooled by the knowledge that a substantial portion of the benefits of that initiative will not be able to be retained. Moreover, the regulation of carrier earnings is not necessary to ensure just and reasonable rates. Rates that comply with the price cap formula are reasonable because they have been kept in line relative to inflation -- and in fact have been forced to decline in real terms -- by the price cap formula itself.

The original reason for including a sharing/automatic stabilizer mechanism as part of the LECs' price cap plan was a concern that the industry-wide productivity offset figure of 2.8% might constitute a significant understatement of an individual price cap LEC's actual inherent productivity performance.[13] As the Commission itself noted:

> As we gain experience with the price cap plan, and that experience boosts confidence in the details of that plan, including our ability to set a productivity factor that reflects a reasonable estimate of projected productivity growth, it may become possible to eliminate the automatic stabilizer.[14]

With that in mind, Ameritech proposes that the price cap LECs' 1994-95 sharing amounts be permanently embedded in their baseline price cap indexes in lieu of the continuation of the sharing mechanism beyond the end of this year. The amount of sharing produced by price cap LECs by the third year of the plan provides, for this purpose, a reasonable estimation (if not an overestimation) of individual LECs' inherent productivity variation from the 2.8% figure at the time price caps began.[15] Moreover, it is likely that any additional sharing in future years beyond these levels would be reasonably attributable to the differential response of the price caps LECs to the new incentives of the price cap plan itself. It is these "achievements" that cannot be stripped from the price cap LECs without seriously undermining the price cap plan itself.

Embedding the 1994-95 sharing amounts permanently into the LECs' price cap indexes and eliminating any further re-examination of LEC earning levels would both compensate customers for any inherent advantages that price cap LECs may have possessed at the beginning of the Commission's price cap plan

---

[13]See, In the Matter of Policy and Rules Concerning Rates for Dominant Carriers, CC Docket No. 87-313, Report and Order and Second Further Notice of Proposed Rulemaking, FCC 89-91 (released April 17, 1989) ("Price Cap Order") at ¶ ¶ 701-709; and Second Report and Order, FCC 90-314 (released October 4, 1990) ("LEC Price Cap Order") at ¶ 120.

[14]Price Cap Order at ¶ 709.

[15]There is significant likelihood, however, that, this far into price caps, LEC sharing amounts may have been raised significantly by efficiency efforts undertaken as a result of incentive regulation itself. It should be noted that Ameritech's 1994 - 95 sharing of $68.7 million is the greatest amount it has had to share under price caps.

and retain the appropriate level of incentives for price cap companies to increase productivity in the future.[16]

Consistent with the elimination of sharing, the automatic lower formula adjustment mechanism should also be eliminated. It seems only reasonable that if the burdens of automatic sharing are eliminated so should the benefits of an automatic lower formula adjustment. Elimination of the lower formula adjustment however would not eliminate LECs' ability to "demonstrate on a case by case basis an adjustment in their allowed rate levels would be necessary to prevent a confiscatory outcome."[17]

E. Common Line Formula

Baseline Issue 5a: Whether the Commission should reconsider its use of the Balanced 50/50 formula to cap common line charges.

Baseline Issue 5b: If so, what method should the Commission use to cap common line charges?

Baseline Issue 5c: If the Commission were to adopt a per-line charge, how should this affect changes in the productivity factor or the composition of baskets, e.g., changes such as the inclusion of common line rates in a public policy basket?

Baseline Issue 5d: What incentives are generated by the current Balanced 50/50 formula, the per line formula, or other possible formulas? What incentives should the formula seek to generate?

---

[16]See, "Price Cap Regulation and Enhanced Competition for Interstate Access Services", National Economic Research Associates, Inc., William E. Taylor, Study Director, April 15, 1993, filed as Tab 1 in Attachment 3 to Ameritech's April 16, 1993, filing of supplemental materials supporting its Petition for Declaratory Ruling and Related Waivers to Establish a New Regulatory Model for the Ameritech Region.

[17]LEC Price Cap Order at ¶ 165.

The FCC's intent was for the Common Line balanced 50/50 formula to split evenly the benefits of growth in minutes per line between the LECs and the IXCs. In reality, however, the LECs do not receive any of the benefits of this growth when viewed in aggregate across all price caps baskets. The 50/50 formula does provide LECs with a portion of the benefit of demand growth within the Common Line basket. However, the 50/50 formula results in a higher productivity offset in the other price cap baskets, compared to the per line formula.

As noted in the NPRM,[18] compared to the per line formula, the 50/50 formula requires a 0.51 percent higher productivity offset.[19] This statement points out a flaw in the initial setting of the productivity offset. The productivity offset, including the 0.51 differential, using the 50/50 formula generates the same historical price reductions as the productivity offset using the per line formula across all price cap baskets. Since the two offsets generate the same price changes in aggregate, the 50/50 formula does not result in any retention of the benefits of minutes growth. In other words, the initial productivity offset was 0.51 percent too high based on the average of the two FCC studies. In order to receive half the benefit of usage growth, the productivity offset generated by the per line formula should have been used for all baskets along with the 50/50 Common Line PCI formula, not the productivity offset generated by the 50/50 formula. The Commission should, therefore, modify the formula so that it results in price cap LECs' receiving a full 50% of the benefit of usage growth.

---

[18]NPRM at note 78.

[19]This difference in the productivity offset was determined by comparing the results of the Frentrup-Uretsky model using the 50/50 formula and the per line formula. The LEC Price Cap Order stated that the Frentrup-Uretsky X for the 50/50 formula is 3.3 percent, and that the Frentrup-Uretsky X for the per line formula is 2.3 percent, a difference of about 1.0 percent. Since the X factor settled on by the FCC was the average of the Frentrup-Uretsky X and the Spavins-Lande X, the difference between the 50/50 formula X and the per line X is 0.5 percent.

LECs should receive some benefit from usage growth because they stimulate interstate usage in a variety of ways. LEC advertising stimulates calling generally which has a spillover effect on interstate services. In addition, LEC provision of such services as call waiting facilitates completion of calls generally, including interstate calls, as does LEC provision of voice mail services. Moreover, to the extent that LEC facilities are maintained in good repair, usage growth is facilitated. And, finally, the provision of equal access and new services and technologies to the IXCs -- such as SS7 signalling -- helps the IXCs' efforts to stimulate usage.

Ameritech would point out, however, that the anomaly of the CCL charge that gives rise to the unique common line formula is the fact that it is assessed as a usage-based charge on LEC switching but recovers non-traffic sensitive costs that don't have anything to do with LEC switching. That fact makes the CCL charge unsustainable in its current form in a competitive environment. As Ameritech has proposed in its Customers First filing and as has been proposed in other contexts (e.g., USTA's access reform proposal), ultimately these costs should be recovered in a competitively neutral manner from all industry providers.

F. Exogenous Cost Treatment

Baseline Issue 6a: Whether the number of eligible exogenous cost changes should be reduced.

Baseline Issue 6b: Which cost changes should be eligible for exogenous treatment?

The LEC price cap plan should still recognize a full range of exogenous cost possibilities. The Commission has historically recognized and should continue to recognize changes in accounting as appropriate exogenous adjustments in a regulatory regime where baseline rates were based on accounting costs. The purpose of price caps generally is to preclude an automatic recovery in rates of those costs which a carrier can control. The purpose of exogenous cost adjustments is to permit LECs to recover increases in costs that are beyond their control and to deny them the benefits of cost reductions that they could not have influenced. If those LECs were currently under traditional cost of service regulation, accounting changes in many cases would be factored into rates. A useful guideline as to what exogenous costs should be permissible under price caps is to recognize those exogenous cost changes (whether accounting or economic or otherwise) that are beyond the LECs' control and which would have otherwise been included in rates in a cost of service regulation environment. This permits LECs to recover the costs that would have been recognized as recoverable under cost of service regulation while maintaining the price cap plan's incentives in tact.

Baseline Issue 6c: Whether third parties should be allowed to request cost changes eligible for exogenous treatment.

Third parties should not be permitted to request such treatment. Such a mechanism flies in the face of the carrier initiated rate concept inherent in Title II of the Communications Act. That is not to say that the Commission does not have jurisdiction to hear complaints of allegedly unreasonable rates. However, it would be completely inappropriate for customers to seek rate changes outside that context.

G. Service Quality and Infrastructure Monitoring

Baseline Issue 7a: Whether the Commission should increase or revise the monitoring of LECs' network reliability, service quality, and infrastructure development.

Reporting requirements do not need to be increased. The Commission already collects reams of information from price cap LECs on service quality and infrastructure development.[20] Price cap LECs, like all carriers, submit reports on network outages of significant magnitude. Moreover, as LEC services become subject to increasing amounts of competition, reports of LEC services alone provide the Commission with a less accurate picture of the health of the nation's telecommunications network. Conversely, as competition emerges, it will be less important for the Commission to keep track of "the details" since competition or the threat of competition will provide adequate incentive for all carriers to provide reliable, technically advanced service. Nonetheless, to the extent reporting requirements are retained, the Commission should apply them equally to all industry participants -- just as it now requires CAPs to file reports on network outages.[21]

Baseline Issue 7b: Whether the Commission should expand service quality reporting to include services and facilities interconnected with the local network or used to provide similar capabilities such as wireless and coaxial cable.

---

[20]It currently costs Ameritech approximately $350,000 per year to comply with the Commission's ARMIS 43-05, -06, and -07 reporting requirements.

[21]In the Matter of Amendment of Part 63 of the Commission's Rules to Provide for Notification by Common Carriers of Service Disruptions, CC Docket No. 91-273, Memorandum Opinion and Order, FCC 93-491 (released December 1, 1993) at ¶¶ 25-26.

No. For the most part, such services are competitive in nature and developed as "supplements" to the public switched network. To the extent that service quality reporting for price cap LECs is designed as a check against any potential LEC incentive to cut costs by letting rate base service quality decline, such reports are unnecessary in this case for services that were never part of the rate base. LECs providing these services have substantial economic incentives to keeping them operating well. Moreover, it would cost Ameritech an additional $1.5 million initially and over $700,000 annually to expand its reports to cover these services. The cost of this expanded reporting regime would greatly exceed any possible benefit. However, no purpose whatsoever would be served by expanding the requirement for LECs and not requiring other providers of similar services to report as well.

H. New Services

Baseline Issue 8a: Whether the LEC price cap new services requirements propose unnecessary regulatory impediments on the development and introduction of new services.

Baseline Issue 8b: Whether and how LEC price cap new services rules should be modified to encourage innovation and setting reasonable rates.

Yes, the LEC price cap new services requirements do impose unnecessary regulatory impediments to the introduction of new services. For optional new LEC services -- those which do not replace existing services on a mandatory basis and those which have not been ordered by the Commission, such as ONA and interconnection services -- "non-dominant" streamlined regulatory treatment is appropriate -- i.e., tariff filings effective on one days notice. In addition, the Commission's rules should be changed so as not to require a waiver to establish new rate elements for new services.

The Commission has long espoused as one of its goals the encouragement of the introduction of innovative new services. In fact, price cap regulation for LECs was viewed by the FCC as a means of furthering this goal.

> Price cap regulation should spur innovations that result in consumers enjoying a wider range of high quality services at cost-effective prices. This spur to innovation should occur because, quite simply, carriers operating under price caps can make more money in the short term than under existing regulation if they respond to consumer demand for more and better services.[22]

Although the goal was a noble one, the development of the treatment of new services under price caps for LECs has done everything but support the introduction of innovative new services. The rules for filing new services under price caps have changed several times and become more complicated and restrictive, despite the fact that simplification of regulation was one of the Commission's justifications for adopting price caps.

Today, new services are subject to the "flexible" cost-based approach articulated in the Commission's order on the Part 69 ONA proceeding. Under this approach, LECs are required to describe and justify overhead loadings and are permitted to include a risk premium only if they can "provide evidence of comparably risky undertakings by firms in relevant industries, together with the cost of capital associated with the undertakings."[23] Tariffs are filed on 45 days notice.

That these restrictions constitute a disincentive to the investment in the development of new services goes without saying. As the Commission correctly noted when it adopted price caps for LECs, the Commission embraced the goal

---

[22]Price Cap Order at ¶ 43.

[23]In the Matter of Amendments of Part 69 of the Commission's Rules Relating to the Creation of Access Charge Sub Elements for Open Network Architecture and Policy and Rules Concerning Rates for Dominant Carriers, CC Docket Nos. 89-79 and 87-313, Report and Order on Further Reconsideration and Supplemental Notice of Proposed Rulemaking, FCC 91-186 (released July 11, 1991) ("Part 69 ONA Order") at ¶¶ 42-44.

of encouraging innovation and cost effectiveness.[24] However, applying a regulator-managed, cost-plus approach to new services significantly undermines that goal by stifling innovation and fostering inefficiency. The Commission itself has found that, the potentiality of "encouraging innovation and cost-effectiveness . . . militates in favor of flexible treatment of these [new] services."[25] Because of the unavoidable economic distortions it causes, a rigid pricing approach to optional new LEC services "stifles" innovation. Therefore, the Commission initially and correctly concluded that pricing flexibility for new services would "strengthen carrier incentives to innovate."[26]

While some might argue that the Commission's rules do allow LECs the "flexibility" to determine the most economically correct approach to determine cost, the Commission will invariably be called upon to determine the "right" way in the tariffing process. Moreover, the rules still require accounting cost-plus pricing which is inappropriate in this context. In the case of optional new services, this kind of regulatory second-guessing unnecessarily distorts the market, making the regulator, instead of the market, the arbiter of price.

Rather, letting the market function to set the price ceiling of optional new services is completely consistent with the Commission's goals for incentive regulation embodied in price caps. Price caps was designed not only to encourage LECs to implement new technologies to increase efficiency, but also to bring to customers the fruits of those technologies by permitting LECs the ability to price services reflect economic reality.[27] It is only in this latter aspect that price

---

[24] LEC Price Cap Order at ¶¶ 31-32.

[25] Price Cap Order at ¶ 518.

[26] LEC Price Cap Order at ¶ 319.

[27] Id. at ¶ 35.